Table 1

Impacts of Deficit
Reduction on the U.S. Economy

| | 1988 | 1990 | 1995 |
|---|---|---|---|
| GNP (1985 Dollars in Billions) | 30 | 68 | 130 |
| Percent | 0.7 | 1.5 | 2.5 |
| Mortgage Interest Rates (percentage points) | -1.0 | -1.4 | -2.2 |
| Employment (millions of jobs) | 0.5 | 0.6 | 1.1 |
| Percent | 0.4 | 0.5 | 0.9 |
| Income per Household (1985 Dollars) | 350 | 790 | 1450 |
| Residential Investment (1985 Dollars in Billions) | 11.5 | 20.8 | 28.8 |
| Percent | 6.8 | 13.5 | 18.6 |
| Housing Starts (000's) | 150 | 220 | 275 |
| Percent | 8.2 | 15.5 | 22.2 |
| Existing Home Sales (000's) | 300 | 450 | 600 |
| Percent | 10.0 | 15.0 | 20.0 |
| Nonresidential Investment (1985 Dollars in Billions) | 25.1 | 60.4 | 108.9 |
| Percent | 4.6 | 10.4 | 15.2 |
| Percent of GNP (percentage points) | 0.5 | 1.1 | 2.0 |
| Equipment (1985 Dollars in Billions) | 15.2 | 37.4 | 67.6 |
| Percent | 4.2 | 9.9 | 14.7 |
| Structures (1985 Dollars in Billions) | 10.0 | 23.0 | 41.3 |
| Percent | 5.5 | 11.6 | 15.9 |
| Productivity (percent) | 0.5 | 0.9 | 1.6 |
| Trade-Weighted Value of the Dollar (percent) | -9.6 | -10.2 | -12.0 |
| Net Exports (1985 Dollars in Billions) | 30 | 43 | 77 |
| Percent | 19.6 | 29.3 | 44.5 |
| Inflation (percentage points) | 0.3 | 0.2 | -0.6 |

SOURCE: Testimony before the Senate Committee on the Budget on the First Concurrent Budget Resolution for FY 1986, February 22, 1985.

Real Estate Markets

Lower and more stable mortgage interest rates are resulting in impressive gains in resales of existing single-family homes and starts and sales of new homes. Over the first three months of this year resales are expected ot have risen about 6 1/2 percent over the previous quarter to a seasonally-adjusted annual rate of 3 million units. Total housing starts are expected to have reached a seasonally-adjusted annual rate of 1.73 million units, 8 percent above the final quarter of 1984.

This increase in resales and starts is the result of strong improvement in affordability.. In February the NATIONAL ASSOCIATION OF REALTORS® Affordability Index reached 88.7, its highest level since December 1979. This means that a family earning the median income had 88.7 percent of the income needed to qualify to purchase the median-priced existing single-family home.

With stable mortgage rates and family incomes increasing faster than home prices, affordability should continue to improve. The Affordability Index should hit the 90 level during the next several quarters and then plateau at that level as family income growth slows.

With further improvement in affordability, resales are expected to reach the 3.2 million annual rate during the third quarter and average 3.1 million units for the entire year. Similarly, housing starts should increase to an annual rate of 1.83 million units by the second quarter and average 1.79 million units for the year. In 1986 housing market activity should retreat somewhat due to higher mortgage interest rates and a slower economy. Resales should decline about 4 percent to 2.98 million units while starts decline a little over 2 percent to 1.75 million units.

New investment in both commercial and industrial real estate continued at healthy levels during the first quarter of 1985 but should follow vastly different trends over the remainder of 1985 and through 1986. With the office vacancy rate in excess of 10 percent nationwide, it appears that the office building boom is coming to a skretching halt. While the value of new commercial construction put in place increased at a seasonally adjusted annual rate of about 34 percent during the first quarter, only modest increases are expected for the remainder of 1985 and through 1987. In contrast, the industrial vacancy rate is at about 4 percent now and is expected to further decline over the next few years, prompting increasing levels of investment in this type of property.

Special Supplement

## Tax Reform Productivity of Tax Provisions Affecting Commercial Real Estate

With the introduction of the Treasury Tax Reform Proposal and the continuing threat of some form of tax increase this year to reduce the deficit, analysts in both the government and the private sector have been conducting in-depth research into the impact of various provisions of the tax code on the performance of the economy. The underlying principal of tax reform is to reduce marginal personal and corporate tax rates in return for expanding the base of taxable income. The Treasury proposal calls for expanding the tax base through such actions as slowing the rate at which assets are depreciated, repealing the investment tax credit for equipment and the various rehabilitation tax credits for older structures, reducing the deductability of interest expense for both individuals and businesses, repealing the tax exempt status of mortgage revenue bonds, extending "at risk" rules to real estate, and various other changes. Similarly, both the 1982 and 1984 tax bills (TEFRA and TRA, respectively) resulted in increased tax revenues by expanding the tax base as opposed to increasing tax rates. TEFRA repealed the phase in the 200 percent declining balance method of depreciation for equipment as called for by ERTA and enacted a partial basis adjustment for the investment tax credit. TRA lengthened the depreciation period for structures from 15 to 18 years.

The issue that is being researched is the magnitude of the change in economic activity per dollar of tax revenue either gained or lost through various changes in the tax code. For example, how much of a reduction in GNP results from a dollar of tax revenue gained through reducing depreciation deductions as opposed to a dollar of tax revenue gained through repeal of the investment tax credit. If there are significant differences in the impacts of the various potential changes in the tax code, then policy makers seeking to raise a specific amount of tax revenue would know how to minimize the negative impacts on the economy. This type of analysis is rumored to be used by the new leadership in the Treasury Department.

Table 2 presents the results of some of this research which analyzes the impact of various elements of the old Treasury tax reform proposal on a typical commercial real estate investment. These various elements are ranked by both productivity and diffusion. Productivity in this case is defined as dollars of investment in commercial real estate lost per dollar of tax revenue gained. For example, lengthening depreciation schedules for structures as proposed in the initial Treasury proposal would result in roughly $5.30 of this type of investment lost for every $1 of tax revenue gained. Morever, this depreciation proposal is very diffuse since it would effect all depreciable real estate. In contrast, repealing the tax exempt status of mortgage revenue bonds would result in roughly $2.10 of this type of investment lost for every $1 of tax revenue gained. In addition, this provision would impact fewer properties, thus leading to a lower diffusion value.

In addition to productivity and diffusion, the Treasury Department is considering "fairness" which is much more subjectived to calculate and is emerging from the political debate in the Administration and Congress.

Table 2

The Treasury Department's Initial Proposals for Tax Reform Ranked by Productivity and Diffusion Based on Analysis of Typical Commercial Property

| | PRODUCTIVITY | DIFFUSION |
|---|---|---|
| • Replace current 18-year depreciation system with a system which indexes assets basis for inflation and allows a 3% per year deduction. | 5.3 | 4 |
| • Repeal all tax credits for rehabilitation expenses. | 3.0 | 1 |
| • Repeal current capital gains exclusion and instead index asset basis for inflation and tax only "real" gain at reduced marginal tax rates. | 2.7 | 4 |
| • Reduce deductibility of interest expense of trade or business by inflation adjustment. | 2.6 | 4 |
| • Extend "at risk" rules to real estate which allows loss deductions only up to an amount equal to recourse indebtedness and cash. | 2.6 | 3 |
| • Tax partnerships with more than 35 members as corporations. | 2.6 | 2 |
| • Repeal the tax exemption for mortgage revenue bonds and industrial development bonds. | 2.1 | 2 |
| • Limit all non-principal residence interest deductibility to $5,000 plus investment interest and reduce deductible amount by inflation adjustment. | 1.2 | 3 |

1/ The higher the productivity number, the greater the reduction in real estate investment per dollar of tax revenue gained include formula.

2/ The higher the diffusion number, the higher the proposed percentage of the real estate industry affected by this.

Table 3

U.S. ECONOMIC OUTLOOK

| | QUARTERS | | | | | | | | YEARS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | Forecast | | | | | | | Actual | | Forecast | | |
| | 84:4 | 85:1 | 85:2 | 85:3 | 85:4 | 86:1 | 86:2 | 86:3 | 1983 | 1984 | 1985 | 1986 | 1987 |
| AGGREGATE ECONOMY | | | | | | | | | | | | | |
| Gross National Product ($ billions) | 3,759 | 3,829 | 3,877 | 3,929 | 3,981 | 4,029 | 4,075 | 4,120 | 3,305 | 3,663 | 3,904 | 4,101 | 4,402 |
| Percent Change | 7.1 | 7.7 | 5.1 | 5.5 | 5.4 | 5.0 | 4.6 | 4.5 | 7.7 | 10.8 | 6.6 | 5.0 | 7.4 |
| Percent Change (without inflation) | 4.3 | 2.5 | 3.0 | 2.4 | 2.2 | 1.8 | 1.5 | 1.0 | 3.7 | 6.8 | 3.0 | 1.9 | 3.2 |
| Consumption | 3.6 | 5.8 | 2.8 | 3.5 | 2.8 | 3.5 | 2.5 | 3.0 | 4.8 | 5.3 | 3.8 | 3.0 | 2.8 |
| Durables | 14.1 | 10.1 | 3.3 | 5.2 | 3.4 | 4.5 | 2.4 | 3.7 | 12.1 | 13.1 | 6.8 | 3.6 | 4.0 |
| Nondurables | -0.5 | 5.9 | 2.9 | 3.4 | 2.6 | 3.2 | 2.3 | 2.5 | 3.7 | 4.6 | 3.0 | 2.7 | 2.4 |
| Services | 3.3 | 4.1 | 2.5 | 2.9 | 2.7 | 3.4 | 2.6 | 3.2 | 3.4 | 3.2 | 3.4 | 2.9 | 2.8 |
| Residential Investment | -5.9 | 4.8 | 7.3 | 10.9 | 0.1 | -2.1 | -1.4 | -1.9 | 41.7 | 12.2 | 2.2 | 0.8 | 0.4 |
| Nonresidential Investment | 8.5 | 5.3 | 3.0 | 5.1 | 5.7 | 4.3 | 4.6 | 4.1 | 2.5 | 19.8 | 7.3 | 4.7 | 6.1 |
| Structures | 17.2 | 8.3 | -2.7 | 3.2 | 2.2 | 1.4 | 2.7 | 1.9 | -7.8 | 15.6 | 6.6 | 2.0 | 8.9 |
| Equipment | 5.4 | 4.2 | 5.2 | 5.8 | 7.0 | 5.4 | 5.3 | 4.9 | 7.3 | 21.5 | 7.6 | 5.7 | 6.9 |
| Exports | -0.8 | 10.0 | 3.7 | 4.2 | 5.3 | 5.4 | 7.0 | 7.6 | -5.6 | 4.7 | 4.7 | 5.9 | 7.3 |
| Imports | -28.3 | 32.6 | 7.1 | 7.6 | 8.3 | 7.4 | 6.5 | 5.2 | 7.6 | 27.0 | 9.9 | 7.0 | 5.2 |
| Government Purchases | 5.9 | 0.8 | 1.8 | 5.5 | -0.2 | -0.1 | -1.1 | 12.0 | -0.3 | 3.5 | 4.0 | 1.8 | 2.2 |
| Consumption (% of GNP) | 64.7 | 65.2 | 65.2 | 65.3 | 65.4 | 65.7 | 65.9 | 66.2 | 65.8 | 64.8 | 65.3 | 66.0 | 65.7 |
| Residential Investment (% of GNP) | 3.6 | 3.6 | 3.6 | 3.7 | 3.7 | 3.6 | 3.6 | 3.6 | 3.5 | 3.7 | 3.6 | 3.6 | 3.5 |
| Nonresidential Investment (% of GNP) | 12.9 | 12.9 | 12.9 | 13.0 | 13.1 | 13.2 | 13.3 | 13.4 | 11.1 | 12.5 | 13.0 | 13.4 | 13.7 |
| Structures (% of GNP) | 3.6 | 3.6 | 3.6 | 3.6 | 3.6 | 3.6 | 3.6 | 3.6 | 3.2 | 3.5 | 3.6 | 3.6 | 3.6 |
| Equipment (% of GNP) | 9.3 | 9.3 | 9.4 | 9.5 | 9.6 | 9.6 | 9.7 | 9.8 | 7.9 | 9.0 | 9.4 | 9.8 | 10.1 |
| Inventory Change ($ billions) | 36.6 | 38.5 | 44.1 | 29.7 | 30.7 | 24.6 | 20.7 | -18.7 | -13.5 | 58.2 | 35.7 | 2.8 | 2.9 |
| Mfg. Capacity Utilization Rate (%) | 82 | 81 | 81 | 81 | 81 | 81 | 81 | 81 | 75 | 82 | 81 | 81 | 82 |
| Auto Sales (millions of units) | 10.2 | 11.0 | 10.7 | 10.8 | 10.8 | 10.8 | 10.7 | 10.8 | 9.2 | 10.4 | 10.8 | 10.7 | 10.9 |
| Domestic (% of total) | 72.9 | 78.3 | 77.3 | 73.3 | 72.0 | 70.7 | 69.5 | 68.7 | 74.0 | 78.4 | 75.2 | 69.2 | 67.9 |
| Imported (% of total) | 27.1 | 21.7 | 22.7 | 26.7 | 28.0 | 29.3 | 30.5 | 31.3 | 26.0 | 23.6 | 24.8 | 30.8 | 32.1 |
| Manufacturing Industrial Production (% change) | -1.4 | 0.2 | 5.5 | 2.9 | 4.7 | 1.3 | 3.5 | 1.4 | 7.8 | 11.2 | 2.8 | 3.0 | 4.8 |
| Common Market | 1.0 | 2.2 | 2.4 | 4.1 | 3.0 | 1.4 | 2.9 | 1.1 | 0.8 | 3.0 | 2.8 | 2.4 | 1.3 |
| Japan | 11.6 | 4.9 | 1.4 | 4.1 | 0.7 | 11.4 | 3.8 | 2.1 | 3.5 | 11.0 | 5.6 | 4.5 | 1.8 |
| Employment(millions)(civilian:household basis) | 106.0 | 106.6 | 107.1 | 107.5 | 107.9 | 108.2 | 108.4 | 108.6 | 100.8 | 105.0 | 107.3 | 108.5 | 110.5 |
| Percent Change | 2.5 | 2.6 | 1.6 | 1.7 | 1.5 | 1.1 | 0.8 | 0.5 | 1.3 | 4.1 | 2.2 | 1.1 | 1.8 |
| Unemployment Rate (%) (civilian) | 7.2 | 7.3 | 7.3 | 7.3 | 7.4 | 7.5 | 7.7 | 7.9 | 9.6 | 7.5 | 7.3 | 7.8 | 7.8 |
| Personal Income per Household (average)<1> | 39,454 | 40,056 | 40,417 | 40,956 | 41,410 | 41,977 | 42,370 | 42,904 | 35,415 | 38,526 | 40,710 | 42,616 | 45,172 |
| Percent Change -- Year Ago (w/o inflation) | 4.8 | 3.4 | 2.1 | 2.0 | 1.5 | 1.7 | 1.6 | 1.4 | 1.5 | 5.4 | 2.3 | 1.4 | 1.9 |
| Personal Taxes per Household (average) | 7,166 | 7,391 | 7,468 | 7,582 | 7,674 | 7,778 | 7,856 | 7,975 | 6,478 | 6,956 | 7,529 | 7,911 | 8,405 |
| Percent Change -- Year Ago (w/o inflation) | 5.7 | 5.7 | 4.7 | 4.5 | 3.7 | 2.4 | 2.1 | 1.9 | -3.0 | 3.5 | 4.6 | 1.9 | 2.2 |
| Percent of Personal Income | 19.0 | 19.3 | 19.3 | 19.4 | 19.4 | 19.4 | 19.4 | 19.4 | 19.1 | 18.8 | 19.3 | 19.4 | 19.5 |
| Disposable Income per Household (average) | 32,288 | 32,665 | 32,949 | 33,374 | 33,737 | 34,199 | 34,514 | 34,929 | 28,938 | 31,571 | 33,181 | 34,705 | 36,767 |
| Percent Change--Year Ago (w/o inflation) | 4.6 | 3.0 | 1.8 | 1.7 | 1.3 | 1.6 | 1.6 | 1.3 | 2.5 | 5.7 | 1.9 | 1.3 | 1.9 |
| Household Interest Payments (% of total) | 10.4 | 10.4 | 10.5 | 10.8 | 10.8 | 10.7 | 10.7 | 10.7 | 9.8 | 10.4 | 10.6 | 10.6 | 9.9 |
| Net Worth Per Household (average) | 79,817 | 81,597 | 83,561 | 85,767 | 87,333 | 89,892 | 90,690 | 92,493 | 73,838 | 77,705 | 84,564 | 91,366 | 97,303 |
| Percent Change--Year Ago (w/o inflation) | 2.5 | 4.0 | 5.7 | 5.2 | 5.9 | 7.2 | 5.3 | 4.5 | 7.6 | 1.4 | 5.2 | 4.8 | 2.4 |
| Consumer Price Inflation (CPI) | 3.5 | 3.1 | 3.5 | 3.3 | 3.4 | 3.6 | 3.6 | 3.7 | 3.2 | 4.3 | 3.4 | 3.5 | 4.3 |
| Gross National Product Inflation (GNP Deflator) | 2.8 | 5.1 | 2.0 | 3.0 | 3.1 | 3.1 | 3.1 | 3.5 | 3.8 | 3.8 | 3.4 | 3.1 | 4.0 |
| Personal Consumption Inflation | 2.4 | 3.6 | 3.0 | 2.8 | 3.1 | 3.2 | 3.3 | 3.4 | 3.7 | 3.2 | 3.1 | 3.2 | 4.0 |
| Residential Construction Inflation | 0.9 | 1.4 | 1.7 | 2.7 | 3.3 | 3.5 | 3.9 | 3.7 | 1.7 | 3.9 | 2.6 | 3.4 | 4.5 |
| Nonresidential Construction Inflation | 1.1 | 0.2 | 2.2 | 3.0 | 3.4 | 3.8 | 3.7 | 3.7 | -1.0 | 0.3 | 1.6 | 3.5 | 4.5 |
| Producers Price Inflation (WPI) | 0.5 | -2.1 | 1.3 | 1.8 | 2.3 | 2.6 | 2.5 | 2.9 | 1.3 | 2.4 | 0.2 | 2.4 | 3.7 |
| Compensation per Manhour (% change) | 3.6 | 6.2 | 3.9 | 4.1 | 4.6 | 5.3 | 4.4 | 4.6 | 4.8 | 4.2 | 4.4 | 4.6 | 5.8 |
| Productivity (% change) | 2.7 | 1.2 | 2.0 | 1.6 | 1.6 | 1.2 | 1.1 | 1.4 | 3.4 | 2.8 | 1.7 | 1.4 | 1.8 |
| Unit Labor Cost (% change) | 0.8 | 5.0 | 1.8 | 2.4 | 3.0 | 4.0 | 3.2 | 3.1 | 1.3 | 1.4 | 2.7 | 3.2 | 3.9 |
| Unit Capital Cost (% change) | 4.3 | 4.1 | 3.8 | 3.5 | 3.1 | 2.7 | 2.4 | 2.1 | 6.9 | 4.6 | 3.6 | 2.3 | 1.7 |
| Before Tax Corporate Profits ($ billions)<2> | 238 | 230 | 235 | 228 | 234 | 221 | 227 | 210 | 213 | 244 | 232 | 221 | 250 |
| Corporate Tax Liability | 95 | 89 | 91 | 87 | 90 | 85 | 88 | 79 | 86 | 98 | 89 | 85 | 99 |
| After Tax Profits | 142 | 141 | 145 | 141 | 144 | 136 | 139 | 131 | 127 | 146 | 143 | 136 | 151 |
| Inventory Valuation Adjustment | -2 | 5 | -2 | -9 | -11 | -13 | -13 | -15 | -11 | -6 | -4 | -14 | -22 |
| Capital Consumption Adjustment | 65 | 70 | 76 | 81 | 86 | 89 | 92 | 93 | 33 | 56 | 78 | 92 | 89 |
| Profits from Current Production (with IVA, CCA) | 205 | 216 | 218 | 213 | 219 | 212 | 217 | 210 | 149 | 196 | 216 | 214 | 219 |
| Adjusted for Inflation (84:3 base) | 204 | 212 | 213 | 207 | 210 | 202 | 205 | 197 | 156 | 197 | 210 | 202 | 198 |
| Percent Change - Year Ago | 12.8 | 12.5 | 8.2 | 3.4 | 3.1 | -4.5 | -3.6 | -4.5 | 46.0 | 26.7 | 6.7 | -4.1 | -1.8 |
| Per Unit of Output (% of GNP) | 5.5 | 5.6 | 5.6 | 5.4 | 5.5 | 5.3 | 5.3 | 5.1 | 4.5 | 5.4 | 5.5 | 5.2 | 5.0 |
| Effective Corporate Tax Rate (%)<2> | 30 | 28 | 28 | 28 | 28 | 28 | 28 | 26 | 34 | 32 | 28 | 27 | 30 |
| Federal Tax Receipts (Unified basis) | 665 | 657 | 846 | 751 | 690 | 685 | 932 | 763 | 613 | 683 | 736 | 777 | 841 |
| Percent of GNP | 17.7 | 17.1 | 21.8 | 19.1 | 17.3 | 17.0 | 22.9 | 18.5 | 18.6 | 18.7 | 18.9 | 18.9 | 19.1 |
| Federal Expenditures (Unified basis) | 954 | 934 | 943 | 959 | 966 | 980 | 989 | 1,005 | 803 | 868 | 951 | 1,001 | 1,071 |
| Percent of GNP | 25.4 | 24.4 | 24.3 | 24.4 | 24.3 | 24.3 | 24.3 | 24.4 | 24.3 | 23.7 | 24.3 | 24.4 | 24.3 |
| Surplus or Deficit (Unified basis) | -290 | -278 | -97 | -208 | -276 | -295 | -57 | -242 | -190 | -184 | -215 | -224 | -230 |
| % of GNP | 7.7 | 7.3 | 2.5 | 5.3 | 6.9 | 7.3 | 1.4 | 5.9 | 5.8 | 5.0 | 5.5 | 5.5 | 5.2 |
| % of Personal Savings | 177.7 | 194.9 | 71.4 | 152.6 | 204.0 | 215.8 | 43.5 | 186.9 | 158.1 | 117.2 | 155.7 | 174.1 | 162.2 |
| % of Net Domestic Savings | 85.0 | 83.7 | 29.5 | 65.8 | 85.7 | 96.6 | 18.5 | 84.2 | 80.0 | 56.4 | 66.2 | 75.7 | 73.7 |

<1> Includes personal contributions for social insurance.
<2> Adjusted to include impact of windfall profits tax on domestic crude oil production.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Dr. Richard Peach, and Janemarie Mulvey.

Table 4

REAL ESTATE AND FINANCIAL MARKETS

| | QUARTERS | | | | | | | YEARS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | Forecast | | | | | | Actual | | Forecast | | |
| | 84:4 | 85:1 | 85:2 | 85:3 | 85:4 | 86:1 | 86:2 | 86:3 | 1983 | 1984 | 1985 | 1986 | 1987 |
| REAL ESTATE MARKETS | | | | | | | | | | | | | |
| Total Single-Family Home Sales (thousands) | 3,826 | 4,063 | 4,248 | 4,320 | 4,229 | 4,173 | 4,148 | 3,946 | 3,730 | 3,936 | 4,215 | 4,038 | 3,849 |
| (single-family resales and completions) | | | | | | | | | | | | | |
| Percent Change -- Year Ago | 0.5 | -1.8 | 4.7 | 16.0 | 10.5 | 2.7 | -2.4 | -8.6 | 42.4 | 5.0 | 7.1 | -4.2 | -4.7 |
| Existing Single-Family Home Sales (thousands) | 2,813 | 2,977 | 3,099 | 3,200 | 3,125 | 3,100 | 3,075 | 2,899 | 2,716 | 2,866 | 3,100 | 2,975 | 2,783 |
| Percent Change - Year Ago | 1.0 | 2.1 | 4.2 | 15.8 | 11.1 | 4.1 | -0.8 | -9.4 | 36.3 | 5.5 | 8.2 | -4.1 | -6.4 |
| Dollar Volume (billions) | 242.2 | 259.2 | 274.2 | 283.3 | 270.4 | 273.1 | 277.2 | 263.1 | 224.2 | 247.1 | 271.8 | 266.1 | 257.5 |
| Existing Home Prices - Median ($1000's) | 72.0 | 73.6 | 75.4 | 76.0 | 74.6 | 76.3 | 78.4 | 79.1 | 69.8 | 72.3 | 74.9 | 77.8 | 81.0 |
| Percent Change - Year Ago | 2.8 | 3.2 | 3.7 | 3.8 | 3.7 | 3.7 | 3.9 | 4.1 | 3.2 | 3.5 | 3.6 | 3.9 | 4.1 |
| Monthly Mortgage Payment (P&I, 80%, 30 yr.) | 656 | 647 | 644 | 653 | 637 | 651 | 669 | 695 | 633 | 665 | 645 | 675 | 722 |
| Percent of Median Family Income | 30 | 29 | 29 | 29 | 28 | 28 | 29 | 29 | 32 | 31 | 29 | 29 | 29 |
| Private Housing Starts (thousands) | 1,398 | 1,734 | 1,826 | 1,809 | 1,798 | 1,765 | 1,763 | 1,727 | 1,703 | 1,766 | 1,792 | 1,750 | 1,745 |
| Percent Change - Year Ago | -6.9 | -10.9 | -1.7 | 8.8 | 12.5 | 1.8 | -3.5 | -4.5 | 61.0 | 3.8 | 1.4 | -2.3 | -0.3 |
| Single-Family | 1,045 | 1,119 | 1,183 | 1,155 | 1,138 | 1,106 | 1,107 | 1,080 | 1,066 | 1,103 | 1,149 | 1,097 | 1,099 |
| Percent of Total | 65.4 | 64.6 | 64.9 | 63.8 | 63.3 | 62.7 | 62.8 | 62.5 | 62.6 | 62.4 | 64.1 | 62.7 | 62.9 |
| Multi-Family | 353 | 615 | 642 | 655 | 660 | 659 | 656 | 647 | 637 | 664 | 643 | 653 | 646 |
| Percent of Total | 34.6 | 35.4 | 35.1 | 36.2 | 36.7 | 37.3 | 37.2 | 37.5 | 37.4 | 37.6 | 35.9 | 37.3 | 37.1 |
| Mobile Home Shipments | 292 | 275 | 292 | 302 | 313 | 315 | 331 | 321 | 296 | 295 | 295 | 323 | 319 |
| New Single-Family Home Sales (thousands) | 617 | 629 | 660 | 668 | 624 | 631 | 623 | 612 | 627 | 637 | 645 | 614 | 588 |
| Percent Change - Year Ago | -8.8 | -7.9 | 4.3 | 8.7 | 1.1 | 0.3 | -5.6 | -8.3 | 49.9 | 1.5 | 1.3 | -4.8 | -4.2 |
| New Home Prices - Median ($1000's) | 80.3 | 82.2 | 82.7 | 83.5 | 84.4 | 85.4 | 86.4 | 87.5 | 75.5 | 80.0 | 83.2 | 87.0 | 91.8 |
| Percent Change - Year Ago | 5.8 | 5.4 | 2.8 | 2.7 | 5.2 | 4.0 | 4.5 | 4.7 | 8.9 | 6.0 | 4.0 | 4.5 | 5.6 |
| New Home Prices--Mean ($1000's, Quality Adjusted) | 95.0 | 95.1 | 95.4 | 96.7 | 97.1 | 97.7 | 98.6 | 100.2 | 89.7 | 93.6 | 96.1 | 99.3 | 103.8 |
| Percent Change - Year Ago | 5.3 | 4.5 | 2.1 | 1.7 | 2.3 | 2.8 | 3.3 | 3.6 | 2.1 | 4.4 | 2.6 | 3.4 | 4.5 |
| NAR Affordability Index | 86.2 | 87.9 | 86.8 | 91.7 | 89.0 | 89.8 | 87.9 | 88.9 | 82.0 | 86.2 | 88.8 | 88.9 | 89.9 |
| New Mortgage Commitments ($ billions) | 195.6 | 183.4 | 181.3 | 186.8 | 190.8 | 203.9 | 189.8 | 198.5 | 163.4 | 193.0 | 185.6 | 195.4 | 213.3 |
| Percent Change - Year Ago | 19.2 | -6.1 | -12.2 | 4.4 | -2.5 | 11.2 | 4.7 | 6.3 | 152.1 | 18.1 | -3.9 | 5.3 | 9.2 |
| Mortgage Debt Outstanding ($ billions) | 2,033 | 2,127 | 2,224 | 2,310 | 2,405 | 2,328 | 2,290 | 2,255 | 1,752 | 1,953 | 2,266 | 2,282 | 2,287 |
| Homeowners' Equity ($ billions)<1> | 1,480 | 1,496 | 1,511 | 1,527 | 1,547 | 1,569 | 1,593 | 1,617 | 1,553 | 1,503 | 1,520 | 1,606 | 1,704 |
| Housing Inventory (millions) | 91.7 | 92.0 | 92.4 | 92.7 | 93.1 | 93.5 | 93.9 | 94.3 | 89.6 | 91.1 | 92.6 | 94.1 | 95.6 |
| Rental Vacancy Rate (%) | 6.3 | 6.2 | 6.1 | 6.0 | 5.8 | 5.8 | 5.8 | 5.8 | 5.6 | 5.9 | 6.0 | 5.8 | 5.8 |
| Unsold New Homes (% of sales) | 55.4 | 53.3 | 59.7 | 61.9 | 69.3 | 69.2 | 75.1 | 68.7 | 42.9 | 50.7 | 61.0 | 71.1 | 69.5 |
| Office Vacancy Rate (%)<2> | 14.7 | 10.7 | 10.4 | 10.1 | 9.9 | 9.7 | 9.5 | 9.4 | 11.7 | 13.9 | 10.3 | 9.5 | 9.1 |
| Industrial Vacancy Rate (%)<2> | 4.7 | 4.0 | 3.9 | 3.8 | 3.8 | 3.7 | 3.7 | 3.6 | 4.9 | 4.7 | 3.9 | 3.6 | 3.4 |
| New Commercial Building Construction (% Ch Value) | 50.8 | 33.6 | -2.0 | 3.8 | -0.1 | 5.0 | -1.5 | 2.5 | -4.2 | 37.1 | 20.7 | 1.3 | 2.7 |
| New Industrial Building Construction (% Ch Value) | 23.0 | 12.1 | 21.2 | 8.1 | 22.1 | 9.9 | 19.8 | 0.8 | -25.7 | 11.6 | 15.1 | 14.4 | 18.3 |
| FINANCIAL MARKETS | | | | | | | | | | | | | |
| Money Supply | | | | | | | | | | | | | |
| M1 (% change)(FED Target 4-7%) | 3.3 | 11.3 | 5.5 | 5.6 | 5.4 | 8.0 | 5.3 | 6.1 | 11.2 | 6.9 | 8.4 | 5.6 | 5.5 |
| M1 Velocity (% change) | 3.7 | -3.1 | -0.4 | -0.1 | 0.0 | -1.0 | -0.6 | -1.5 | -3.2 | 3.7 | 0.1 | -0.6 | 1.7 |
| M2 (% change)(FED Target 6-9%) | 9.3 | 13.0 | 7.6 | 5.2 | 5.6 | 6.2 | 7.1 | 7.3 | 12.5 | 7.9 | 8.7 | 6.4 | 6.7 |
| M2 Velocity (% change) | -2.0 | -4.7 | -2.4 | 0.3 | -0.3 | -1.2 | -2.3 | -2.6 | -4.4 | 2.7 | -2.0 | -1.3 | 0.6 |
| Monetary Base (% change) | 4.5 | 8.7 | 4.4 | 5.5 | 4.8 | 5.5 | 4.8 | 5.6 | 9.5 | 8.1 | 6.2 | 5.1 | 5.9 |
| Flow of Funds (NIA Basis) | | | | | | | | | | | | | |
| Sources (total:gross savings) | 653 | 666 | 676 | 668 | 685 | 694 | 708 | 676 | 479 | 654 | 674 | 692 | 747 |
| Private | | | | | | | | | | | | | |
| Personal Savings | 163 | 143 | 135 | 137 | 135 | 137 | 131 | 130 | 118 | 156 | 137 | 130 | 141 |
| Savings Rate | 6.2 | 5.3 | 5.0 | 5.0 | 4.8 | 4.8 | 4.6 | 4.5 | 5.0 | 6.1 | 5.0 | 4.5 | 4.6 |
| Gross Business Savings | 536 | 551 | 557 | 556 | 566 | 564 | 575 | 575 | 454 | 519 | 557 | 576 | 610 |
| Government | | | | | | | | | | | | | |
| Federal | -197 | -184 | -188 | -193 | -199 | -186 | -189 | -211 | -179 | -176 | -191 | -200 | -208 |
| State and Local | 56 | 58 | 61 | 58 | 59 | 51 | 56 | 46 | 44 | 53 | 59 | 52 | 59 |
| Foreign (current account deficit) | 95 | 99 | 111 | 115 | 124 | 128 | 134 | 137 | 42 | 102 | 112 | 135 | 145 |
| Uses (total:gross investment) | 638 | 649 | 662 | 661 | 672 | 675 | 681 | 651 | 472 | 638 | 661 | 669 | 727 |
| Nonresidential Investment | | | | | | | | | | | | | |
| Equipment | 290 | 293 | 298 | 303 | 310 | 316 | 323 | 329 | 223 | 275 | 301 | 326 | 362 |
| Structures | 158 | 161 | 161 | 163 | 166 | 168 | 171 | 173 | 130 | 150 | 163 | 172 | 187 |
| Residential Investment | 154 | 156 | 159 | 164 | 166 | 166 | 167 | 168 | 132 | 154 | 161 | 168 | 176 |
| Inventory Investment | 37 | 38 | 44 | 30 | 31 | 25 | 21 | -19 | -13 | 58 | 36 | 3 | 3 |
| Value of the U.S. Dollar (Weighted by Trade) (Base=1967) | 1.143 | 1.201 | 1.175 | 1.155 | 1.135 | 1.116 | 1.098 | 1.081 | 1.024 | 1.095 | 1.167 | 1.090 | 1.028 |
| Percent Change | 8.9 | 22.0 | -8.5 | -6.5 | -6.7 | -6.6 | -6.5 | -5.9 | 3.7 | 6.9 | 6.6 | -6.6 | -5.7 |
| Selected Interest Rates (Percent) | | | | | | | | | | | | | |
| Mortgage Commitment Rates | | | | | | | | | | | | | |
| 30 Year,Fixed-Rate | 14.0 | 13.5 | 13.1 | 13.2 | 13.1 | 13.1 | 13.1 | 13.5 | 13.8 | 14.2 | 13.2 | 13.3 | 13.7 |
| Real Mortgage Rate (30 yr. avg. is 4.5%) | 11.3 | 8.6 | 11.0 | 10.2 | 10.0 | 10.0 | 10.0 | 10.0 | 10.2 | 10.5 | 9.9 | 10.0 | 9.8 |
| 1 Year ARM (without buy-down) | 11.7 | 11.2 | 11.4 | 11.4 | 11.4 | 11.5 | 11.4 | 11.2 | 11.3 | 12.6 | 11.3 | 11.4 | 11.6 |
| Real Mortgage Rate | 9.0 | 6.1 | 9.4 | 8.4 | 8.3 | 8.4 | 8.3 | 7.7 | 7.5 | 9.0 | 8.0 | 8.0 | 7.2 |
| Corporate Bond Rate (AAA) | 12.3 | 12.2 | 12.2 | 12.3 | 12.3 | 12.3 | 12.4 | 12.4 | 12.0 | 12.7 | 12.2 | 12.4 | 12.8 |
| Government Bond Rate | 11.8 | 11.7 | 11.6 | 11.7 | 11.8 | 11.8 | 11.8 | 11.9 | 11.3 | 12.5 | 11.7 | 11.9 | 12.2 |
| Real Government Bond Rate (30 yr. avg. is 2.1%) | 9.0 | 6.6 | 9.6 | 8.7 | 8.7 | 8.7 | 8.7 | 8.4 | 7.6 | 8.9 | 8.4 | 8.5 | 7.8 |
| Federal Funds Rate | 9.3 | 8.6 | 8.7 | 9.0 | 9.2 | 9.3 | 9.3 | 9.5 | 9.1 | 10.2 | 8.9 | 9.3 | 9.9 |
| 3 Month Treasury Bill Rate | 8.8 | 8.3 | 8.5 | 8.6 | 8.7 | 8.8 | 8.9 | 9.0 | 8.6 | 9.5 | 8.5 | 8.8 | 9.0 |
| Real 3 Month T-Bill Rate (30 yr. avg is 1.2%) | 6.1 | 3.2 | 6.5 | 5.6 | 5.6 | 5.7 | 5.8 | 5.5 | 4.8 | 5.9 | 5.2 | 5.5 | 4.6 |
| 1 Year Treasury Bill Rate | 10.0 | 9.5 | 9.7 | 9.7 | 9.7 | 9.8 | 9.7 | 9.5 | 9.6 | 10.9 | 9.6 | 9.7 | 9.9 |
| Real 1 Year T-Bill Rate (30 yr. avg is 1.7%) | 7.3 | 4.4 | 7.7 | 6.7 | 6.6 | 6.7 | 6.6 | 6.0 | 5.8 | 7.3 | 6.3 | 6.3 | 5.5 |
| Commercial Paper Rate | 9.2 | 8.6 | 8.8 | 9.0 | 9.1 | 9.2 | 9.2 | 9.1 | 8.9 | 10.1 | 8.9 | 9.2 | 9.8 |
| Rate on Money Market Fund Shares | 9.3 | 8.7 | 8.9 | 9.1 | 9.2 | 9.4 | 9.3 | 9.2 | 9.0 | 10.3 | 9.0 | 9.3 | 9.8 |
| Prime Rate | 11.8 | 10.6 | 10.9 | 10.9 | 10.9 | 11.4 | 11.4 | 11.3 | 10.8 | 12.0 | 10.8 | 11.3 | 11.7 |

<1> Homeowners Equity has been adjusted to correspond to the Federal Reserve's Flow of Funds data.
<2> Historical data courtesy of Coldwell Banker.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Dr. Richard Peach and Jannemarie Mulvey

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# OUTLOOK

## FOR THE ECONOMY AND REAL ESTATE

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# Outlook for the Economy and Real Estate

## Aggregate Economy

As the current expansion winds down from the strong pace of the last two years and the trade situation continues to deteriorate, economic activity is expected to remain sluggish through 1985. The downward revision in the first quarter real (inflation-adjusted) growth in GNP to an annualized rate of 1.3 percent underscores slowing growth in nearly all sectors of the economy.

Just as consumer spending led the recovery, a slowdown in this component is now bringing the economy to a soft landing. Because spending increases have exceeded income gains by as much as 75 percent over the last four months, consumers are now trying to reduce their debt burdens. Thus, a subsequent decline in the personal savings rate and an inevitable fall in consumption has begun to occur. In contrast to the high levels of expenditures on durables that occured in 1984, the growth rate for durables during the first quarter of 1985 of 6.9 percent was only half of the growth experienced last year. Growth in total consumption is expected to slow through 1985 from the strong pace of 1984 and will therefore put further downward pressure on overall output growth of the economy during 1985 and 1986.

Growth in business fixed investment, which provided a strong stimulus to the current recovery, is also beginning to show signs of weakening as slower economic activity and domination of foreign produced capital goods widens the gap between domestic consumption and production. This had led to an undesirable accumulation of domestic inventories in manufacturing and capital goods during the first quarter. In addition, the key determinants of business fixed investment, capacity utilization and corporate profits, have begun to falter leading to a pronounced decline in capital spending during the first quarter. Furthermore, a March decline in new orders for nondefense capital goods, which is usually a good indicator of future capital spending, underscores the continued slowing in investment that is expected through 1985 as both productivity and corporate profits continue to decline.

The major source of the recent weakening in consumer and investment demand has been the continued deterioration in the trade balance. According to the first quarter estimates net exports have declined 26.1 billion, almost twice the fourth quarter decline and an indication of a worsening trade situation during 1985 and 1986. Unfortunately, the recent decline in the dollar is not likely to lead to improvement without a lag of a year or two. The dollar's decline is relative to a peak that lasted only a couple of weeks in February and that "spike" had no direct impacts on trading patterns. In addition, since the lag between foreign orders and deliveries is a minimum of nine months, today's strong import penetration reflects the value of the dollar last summer. Consequently, any improvement in the trade situation would have to accompany a sustained drop in the dollar to levels well below the 2.75 dollar/deutsche mark rate reached last year.

Low inflation and declining interest rates should prevent the economy from entering a full recession as modest gains in the interest sensitive sectors of the economy such as business fixed investment, residential

construction, and consumer durables should provide a positive stimulus to output growth through 1985. However, given the current trade imbalance and the maturity of the expansion, the economy is expected to grow below 2 percent for the remainder of the year before increasing to around 2.3 percent by 1986. By 1987, a gradual depreciation in the dollar should lead to some renewed growth in the economy with total output growth expected to reach 3.5 percent.

Employment and Inflation

Employment in March remained strong with total nonfarm employment increasing a marked 0.4 percent. The improvement in the employment figures can be attributed to strong growth in the service producing sector while employment in manufacturing was little changed. In addition, the civilian unemployment rate in March remained unchanged at 7.3 percent. However, as the economy continues to slow, growth in employment is also expected to decline leading to a gradual increase in the civilian unemployment rate through 1985 as the number of jobs available falls short of new additions to the labor force.

Despite fears of a devalued dollar and slower economic growth pushing prices higher, the short-term outlook for inflation remains favorable. The 0.4 percent increase in the Consumer Price Index (CPI) in March can be attributed to a sharp turnaround in gasoline prices and does not indicate any renewed inflationary pressures for 1985. For all of 1985 consumer prices are expected to increase a modest 3.5 percent followed by 3.7 percent in 1986. By 1987, a gradual devaluation of the dollar from record highs should boost consumer inflation to around 4.3 percent.

Monetary Policy and Interest Rates

After rapid growth in the money supply over the last four months, growth in M1, M2 and M3 has begun to subside with growth rates in March remaining well below their upper targets. This slowing in the money supply underscores the need for a more accomodative monetary policy by the Federal Reserve as economic activity continues to slow.

The goods news about slower economic activity is the subsequent decline in interest rates that will occur as demand continues to weaken. Short term rates after rising in February and March have begun to trend downward. In fact, the rate on 3-month T-bills dipped to its lowest level in two years well below 8 percent in late April. By the second half of 1985, however, rates will begin to drift upward again as mounting federal deficits and a slight rebound in demand will put upward pressure on rates. Long term rates are also expected to trend downward as inflationary expectations remain modest. By the end of 1986, long term rates will begin to trend upward.

Real Estate Markets

Activity in the housing market continues to mark record gains for the 1980's as lower interest rates and moderate inflation provide a boost to affordability for potential homebuyers. Existing home sales climbed to their highest level in 4-1/2 years reaching a seasonally-adjusted annual rate of 3.05 million units in March and are expected to reach a seasonally-adjusted annual rate of 3.1 million units for all of 1985. By 1986, existing home sales should remain strong at 3.0 million units before declining to 2.8 million units in 1987.

Total housing starts also recorded strong gains in March with total starts increasing 16.2 percent. However, most of the increase is due to the extreme volatilty that has occurred in the multi-family starts since December. In March, multi-family starts increased 46 percent after declining 33 percent in February. Total starts are expected to reach a seasonally-adjusted annual rate of 1.8 million units for all of 1985 before declining slightly into 1986 as interest rates begin to trend upward.

Continued declines in mortgage interest rates and improvements in family income helped boost NAR's Affordability Index to 89.4 in March--the highest level in more than 5 years. A decline of nearly 0.25 percentage points in the average effective commitment rate in February was the major reason for the improvement in affordability.

Most components of nonresidential construction are not expected to fare as favorably as residential construction in 1985. The office building boom appears to be receeding from an extraordinary peak and as a result over-building in office space has held the office vacancy rate near 10 percent. Therefore, an extended correction over the next couple of years will dominate with office construction expected to decline from 317 million square feet in 1984 to 275 million square feet for all of 1985.

The strongest component of nonresidential construction will be stores and other commercial construction. The already high levels in retail building are expected to be sustained through 1985 given the strong growth in housing starts that is forecasted. Almost 500 million square feet of retail and other commercial buildings are expected to be contracted in 1985 compared with 477 million square feet in 1984.

Industrial construction, in response to slowing corporate profits and productivity, is also expected to show only modest gains with 150 million square feet expected in 1985, only 4 percent above 1984's levels.

Table 1

Commercial and Industrial Building Contracts

| | Stores and Other Commercial | | Office Buildings | | Industrial Buildings | |
|---|---|---|---|---|---|---|
| | millions of sq ft | percent change | millions of sq ft | percent change | millions of sq ft | percent change |
| Year | | | | | | |
| 1981 | 337 | -11% | 325 | +15% | 187 | -13% |
| 1982 | 245 | -27% | 261 | -20% | 118 | -37% |
| 1983 | 362 | +48% | 281 | + 8% | 107 | -37% |
| 1984 | 477 | +32% | 317 | +13% | 113 | +33% |
| 1985[f] | 496 | + 4% | 275 | -13% | 150 | + 5% |

Source: Historical Data: DRI, Review of the U.S. Economy, December 1984.
Forecasts: NATIONAL ASSOCIATION OF REALTORS®

f Forecast

Special Supplement

# The Impact of Tax Reform on Real Estate

All three of the major tax reform proposals currently under consideration - the Kemp-Kasten "FAST" proposal, the Bradley-Gephardt "FAIR" proposal, and the Treasury Tax Reform Proposal now referred to as Treasury I - would make sweeping changes to the tax law pertaining to both owner-occupied housing and commerical real estate. 1/ This report presents the analysis of the likely impact of these tax reform proposals on these categories of real estate. Assuming that mortgage interest rates remain unchanged, in general tax reform would cause the after-tax cost of owner-occupied residences to rise, resulting in a decline in their value. The declines in value would be greater for higher-priced homes since the typical buyers of such properties would experience a larger decline in marginal tax rates than would the buyers of lower-priced homes. Similarly, tax reform would significantly reduce the yield on commercial real estate, reducing the level of investment in such properties. This in turn will reduce the value of such properties and result in signficant increases in rents in the long-run. Should tax reform cause mortgage interest rates to fall by 1 percentage point, the best that can be expected given the role of foreign investors in determining domestic interest rates, the dire impacts of tax reform on real estate would be only partially mitigated.

## Owner-Occupied Homes

Table 2 presents a side-by-side comparison of the provisions of current tax law which impact the after-tax cost of homeownership with the tax reform proposals under discussion. Current law is expre sed as it is believed it will be in 1986 when the zero bracket amount or standard deduction and exemptions are indexed for inflation.

In general, taxpayers would face lower marginal tax rates under any of the tax reform proposals than they do under current law. As a result, a given dollar amount of itemized deductions results in a reduced amount of tax savings. For example, where $1 of deduction results in $.25 of tax savings with a 25 percent marginal rate, tax savings are reduced to $.15 with a 15 percent marginal rate. The exeption to this generalization is for lower-income taxpayers under Kemp-Kasten where the 24% marginal rate on deductions frequently exceeds the marginal rate under current law. 2/

All three proposals would raise the taxpayer and spouse exemption. Kemp-Kasten and Treasury I would also raise the dependent exemption. Bradley-Gephardt keeps the dependent exemption at $1,000 which is less than 1986 current law since Bradley-Gephardt eliminates indexing. Increasing the value of exemptions tends to raise after-tax homeownership costs since, for a given level of gross income, larger exemptions result in lower taxable income and so are likely to result in a lower marginal tax rate.

Bradley-Gephardt raises the zero bracket amount (ZBA) or standard deduction for a joint return from $3,710 to $6,000 while Treasury I raises it to $3,800 but retains indexing. Increasing the ZBA also reduces the value of a given dollar amount of itemized deductions since it is the amount of such deductions above the ZBA by which taxable income is reduced. In contrast, Kemp-Kasten reduces the ZBA for joint returns, having the opposite effect.

TABLE 2

COMPARISON OF TAX PROVISIONS IMPACTING AFTER-TAX HOMEOWNERSHIP COSTS UNDER ALTERNATIVE TAX REFORM PROPOSALS

| | 1986 Current Law | Bradley-Gephardt | Kemp-Kasten | Treasury I |
|---|---|---|---|---|
| PERSONAL MARGINAL TAX RATES | 14 rate brackets from 11 to 50% | 3 rate brackets 14%, 26%, 30% | 1 rate bracket 24% | 3 rate brackets 15%, 25%, 35% |
| EXEMPTIONS | | | | |
| Self, spouse | $1,090 | $1,600 | $2,000 | $2,000 |
| Dependents | $1,090 | $1,000 | $2,000 | $2,000 |
| Elderly | $1,090 | $1,000 | $2,000 | Credit |
| Blind | $1,090 | $1,000 | $2,000 | Credit |
| ZERO BRACKET AMOUNTS | | | | |
| Single | $2,510 | $3,000 | $2,600 | $2,800 |
| Joint | $3,710 | $6,000 | $3,300 | $3,800 |
| Heads of Household | $2,510 | $3,000 | $2,700 | $3,500 |
| INDEXED RATE BRACKETS, EXEMPTIONS, AND ZBA | Yes | No | Yes | Yes |
| PERSONAL DEDUCTIONS | | | | |
| Mortgage Interest | | | | |
| Principle Residence | Yes | Yes | Yes | Yes |
| Secondary Residence | Yes | Yes | Yes | Treated as other personal interest. |
| Other personal interest | Yes | Limited to net passive investment income. | No, except on education expenses. | Limited to $5,000, plus passive investment income. Amount above $5,000 indexed for inflation. |
| Real Property Taxes | Yes | Yes | Yes | No |
| SPECIAL FEATURES | -- | All deductions at 14% marginal rate | 20% exclusion of employment income up to maximum taxable Social Security Income (indexed), phased out above that income level. | -- |

TABLE 2 (continued)

| | 1986 Current Law | Bradley-Gephardt | Kemp-Kasten | Treasury I |
|---|---|---|---|---|
| OTHER INDIVIDUAL ITEMS | | | | |
| Rollover of Capital Gains on Principal Residence | Capital gain tax deferred if seller purchases another residence costing at least as much as the one sold within two years. | Yes | Yes | Yes |
| One-time Exclusion on Capital Gains on Principal Residence | One-time exclusion of gain up to $125,000 on sale of principal residence for taxpayers 55 or older. | Yes * | Yes | Yes, plus gain is indexed for inflation. |
| FINANCIAL INSTITUTIONS | | | | |
| Special Bad Debt Reserve | Yes | No | No | No |
| MUNICIPAL BONDS | | | | |
| Public purpose | Tax-exempt | Taxed-exempt | Tax-exempt | Tax-exempt |
| Private purpose | Tax-exempt | Taxed | Taxed | Taxed |

Source: NATIONAL ASSOCIATION OF REALTORS

* Excluded from 14 percent base rate only. Not excluded from the 12 percent and 16 percent surtax rates.

All three proposals retain unlimited mortgage interest deductions for principal residences. Bradley-Gephardt and Kemp-Kasten also retain unlimited mortgage interest deductions for secondary residences while Treasury I lumps such deductions in with other personal interest deductions which are limited to $5,000 plus passive investment income were the amount of deductable interest above $5,000 is subject to inflation indexing. Bradley-Gephardt and Kemp-Kasten also retain deductions for real property taxes whereas Treasury I repeals such deductions. Note that while Bradley-Gephardt has a progressive marginal rate structure, all deductions are evaluated at the 14 percent base rate only.

Each of the proposals also retains the existing rollover of capital gains on the sale of a principal residence and the one-time exclusion of capital gains up to $125,000 on the sale of a principal residence by taxpayers 55 or older. However, both Bradley-Gephardt and Treasury I introduce some changes which alter the value of this exclusion. Under Bradley-Gephardt the value of the one-time exclusion is diminished since it applies to the 14 percent base rate but not the 12 and 16 percent surtax rates. Under Treasury I the value of the one-time exclusion is enhanced since the gain on the sale of a principal residence is indexed for inflation.

Tables 3 and 4 present estimated impacts of the various tax reform proposals on the after-tax cost of ownership of a principal residence. Estimates are provided for three home prices - $50,000, $85,000 and $150,000. In Table 3 the estimates are made holding interest rates constant while in Table 4 interest rates are assumed to decline by one percentage point due to the decline in marginal tax rates. 3/ The impacts on actual taxpayers are likely to be slightly different from these examples since they do not account for state income taxes or nonhousing itemized deductions.

If mortgage interest rates remain unchanged, under Treasury I the after-tax cost of owning a $50,000 home would rise about 4.8 percent, resulting in a 5.1 percent decline in the value of this property. Under Kemp-Kasten the after-tax cost of owning this same home would fall about 3.7 percent, resulting in a 4.4 percent increase in value, while under Bradley-Gephardt that cost would rise by about 8.0 percent with value declining 8.6 percent. If mortgage rates were to fall one percentage point the after-tax cost of owning this $50,000 home would fall 1.1 percent under Treasury I, fall 9.0 percent under Kemp-Kasten, and rise 1.5 percent under Bradley-Gephardt. The corresponding impacts on the value of this property would be plus 1.2 percent, plus 11.6 percent, and minus 1.7 percent. 4/

The impact on higher-priced homes is much more severe due to the larger decline in marginal tax rates. For example, with mortgage rates unchanged, under Bradley-Gephardt the after-tax cost of owning a $150,000 home would rise by 30.7 percent, resulting in a 24.7 percent decline in value. Under Treasury I the after-tax cost of this same property would rise 21.5 percent, causing value to decline 18.8 percent. Under Kemp-Kasten, after-tax cost would rise 16.0 percent and value would decline by 14.5 percent. With a one percentage point decline in mortgage rates Bradley-Gephardt would result in a 22.3 percent increase in after-tax cost and 19.5 percent decline in value. Under Treasury I the corresponding impacts are plus 14.5 percent and minus 13.6 percent while under Kemp-Kasten they are plus 8.8 percent and minus 8.6 percent.

TABLE 3

COMPARISON OF AFTER-TAX HOMEOWNERSHIP COSTS
UNDER ALTERNATIVE TAX REFORM PROPOSALS 1/
(MORTGAGE RATES UNCHANGED)

EXAMPLE #1 — Cost of Home - $50,000; Required Income - $21,500

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $6,200 | $6,200 | $6,200 | $6,200 |
| Marginal Tax Rate (%) | 18% | 15% | 24% | 14% |
| Tax Savings ($) | 487 | 210 | 696 | 28 |
| After Tax Cost ($) | 5,713 | 5,990 | 5,504 | 6,172 |
| Change in Cost ($) | - - | +277 | -209 | +459 |
| Change in Cost (%) | - - | +4.8% | -3.7% | +8.0% |
| Change in Home Value (%) | - - | -5.1% | +4.4% | -8.6% |
| Impact on Home Sales (%) | - - | -10% | +8% | -17% |

EXAMPLE #2 — Cost of Home - $85,000; Required Income - $36,000

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $10,540 | $10,540 | $10,540 | $10,540 |
| Marginal Tax Rate (%) | 25% | 15% | 24% | 14% |
| Tax Savings ($) | 1,851 | 756 | 1,738 | 636 |
| After Tax Cost ($) | 8,689 | 9,784 | 8,802 | 9,904 |
| Change in Cost ($) | - - | +1,095 | +113 | +1,215 |
| Change in Cost (%) | - - | +12.6% | +1.3% | +14.0% |
| Change in Home Value (%) | - - | -11.9% | -1.4% | -13.4% |
| Impact on Home Sales (%) | - - | -24% | -2% | -26% |

EXAMPLE #3 — Cost of Home - $150,000; Required Income - $ 64,000

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $18,600 | $18,600 | $18,600 | $18,600 |
| Marginal Tax Rate (%) | 38% | 25% | 24% | 14% |
| Tax Savings ($) | 5,718 | 2,950 | 3,672 | 1,764 |
| After Tax Cost ($) | 12,882 | 15,650 | 14,928 | 16,836 |
| Change in Cost ($) | - - | +2,768 | +2,046 | +3,954 |
| Change in Cost (%) | - - | +21.5% | +16.0% | +30.7% |
| Change in Home Value (%) | - - | -18.8% | -14.5% | -24.7% |
| Impact on Home Sales (%) | - - | -34% | -25% | -48% |

1/ All examples assume a 20 percent downpayment, a 30 year fixed rate mortgage with a 13 percent interest rate, and property taxes equal to 2 percent of the home value. Required income assumes 25 percent of income is devoted to principal and interest payments. All tax calculations assume a joint return with four exemptions.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

TABLE 4

COMPARISON OF AFTER-TAX HOMEOWNERSHIP COSTS
UNDER ALTERNATIVE TAX REFORM PROPOSALS 1/
(MORTGAGE RATES DECLINE BY ONE PERCENTAGE POINT)

EXAMPLE #1 — Cost of Home - $50,000; Required Income - $21,500

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $6,200 | $5,800 | $5,800 | $5,800 |
| Marginal Tax Rate (%) | 18% | 15% | 24% | 14% |
| Tax Savings ($) | 487 | 150 | 600 | 0 |
| After Tax Cost ($) | 5,713 | 5,650 | 5,200 | 5,800 |
| Change in Cost ($) | - - | -63 | -513 | +87 |
| Change in Cost (%) | - - | -1.1% | -9.0% | +1.5% |
| Change in Home Value (%) | - - | +1.2% | +11.6% | -1.7% |
| Impact on Home Sales (%) | - - | +3% | +18% | -4% |

EXAMPLE #2 — Cost of Home - $85,000; Required Income - $36,000

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $10,540 | $ 9,860 | $ 9,860 | $ 9,860 |
| Marginal Tax Rate (%) | 25% | 15% | 24% | 14% |
| Tax Savings ($) | 1,851 | 654 | 1,574 | 540 |
| After Tax Cost ($) | 8,689 | 9,206 | 8,286 | 9,319 |
| Change in Cost ($) | - - | +517 | -403 | +630 |
| Change in Cost (%) | - - | +6.0% | -4.6% | +7.3% |
| Change in Home Value (%) | - - | -6.0% | +5.4% | -7.4% |
| Impact on Home Sales (%) | - - | -11% | +9% | -14% |

EXAMPLE #3 — Cost of Home - $150,000; Required Income - $ 64,000

| | Current Law | Treasury I | Kemp-Kasten | Bradley-Gephardt |
|---|---|---|---|---|
| Before Tax Cost ($) | $18,600 | $17,400 | $17,400 | $17,400 |
| Marginal Tax Rate (%) | 38% | 25% | 24% | 14% |
| Tax Savings ($) | 5,718 | 2,650 | 3,384 | 1,596 |
| After Tax Cost ($) | 12,882 | 14,750 | 14,016 | 15,804 |
| Change in Cost ($) | - - | +1,868 | +1,134 | +2,992 |
| Change in Cost (%) | - - | +14.5% | +8.8% | +22.3% |
| Change in Home Value (%) | - - | -13.6% | -8.6% | -19.5% |
| Impact on Home Sales (%) | - - | -23% | -14% | -36% |

1/ All examples assume a 20 percent downpayment, a 30 year fixed rate mortgage with a 13 percent interest rate, and property taxes equal to 2 percent of the home value. Required income assumes 25 percent of income is devoted to principal and interest payments. All tax calculations assume a joint return with four exemptions.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

At this point it is important to address two common misconceptions about the impact of tax reform on homeownership. First, it has been suggested that homeownership would not be adversely affected by tax reform for even though after-tax homeownership costs may rise, it is also true that a taxpayers disposable or after-tax income will also rise, offsetting the increase in homeownership costs. Second, it has been suggested that the resulting decline in home prices will improve affordability and therefore aid first-time homebuyers and current homeowners who wish to move up the housing ladder.

In regard to the first misconception, it is important to note that the tax savings provided by the homeownership deductions are conditional upon owning a home and so must be used to reduce the cost of owning that home. Therefore, implicitly a homeowner pays the same tax and has the same disposable income as a renter with the same income, exemptions, non-housing itemized deductions, etc. Using Treasury I as an example, Table 5 presents the impacts of tax reform on a homeowner with an adjusted gross income of $36,000 who owns an $85,000 home under the assumptions described in Table 3. Treasury I would actually boost this homeowners implicit disposable income by $1,755 but raise after-tax homeownership costs by $1,095. After-tax homeownership costs would rise from 28.4 percent of disposable income to 30.2 percent, reflecting the increase in the relative price of homeownership. The net impact is that this homeowner would have $660 of additional disposable income to spend on other goods and services. However, this amount would decline to $200 to $300 when the decline in value of all other itemized deductions is taken into account. The bottom line is that the price of homeownership would rise relative to the price of all other goods and services, leading consumers to demand less of it.

Table 5

NET IMPACT OF TREASURY TAX PLAN ON HOMEOWNING TAXPAYER
FAMILY OF FOUR, FILING JOINTLY
(Taxable Year 1984)

| | Current Law | Treasury Plan | Change |
|---|---|---|---|
| Adjusted gross income | $36,000 | $36,000 | -- |
| Income tax without homeownership tax deductions | 5,385 | 3,630 | -1,755 |
| Disposable income | 30,615 | 32,370 | +1,755 |
| After-tax cost of homeownership | 8,689 | 9,784 | +1,095 |
| Percent of disposable income | 28.4% | 30.2% | +1.8% |
| Disposable income available for all other goods and services | 21,926 | 22,586 | +660 |

SOURCE: NATIONAL ASSOCIATION OF REALTORS®